

**Meeting Between Federal Reserve Board Staff  
and Representatives of the Loan Syndication and Trading Association (LSTA)  
September 7, 2010**

**Participants:** Matthew Eichner, Andreas Lehnert, William Bassett, Steven Merriett, Thomas Boemio, Fabio Natalucci, Sean Chu, Kathleen Hanley, Kieran Fallon, April Snyder, Benjamin McDonough, and Flora Ahn (Federal Reserve Board)

Bram Smith, Meredith Coffey, and Elliot Ganz (LSTA)

**Summary:** Staff of the Federal Reserve Board met with representatives of LSTA. LSTA's representatives provided Federal Reserve Board staff a presentation on collateralized loan obligations ("CLOs") and presented their overall views on how risk retention requirements may impact the syndicated loan market and CLOs, as reflected in the attached materials submitted by LSTA at or prior to the meeting.

In addition to the matters discussed in the attached materials, LSTA's representatives also reviewed with Federal Reserve Board staff the results of a confidential survey conducted by LSTA of CLO managers with respect to their views on varying types and degrees of risk retention requirements.

Among other matters discussed during the meeting were: the composition of CLOs; recent performance of CLOs in comparison with other asset-backed securities; the value of CLOs to the credit market; which entities may be considered as securitizers or originators; the different forms of risk retention; the potential impact of risk retention on the syndicated loan market; and possible interpretations for what it means to retain credit risk.

Attachment



The LSTA<sup>1</sup> would like to highlight how language in Title IX, Subtitle D, Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act could materially impact the syndicated loan market. Syndicated loans in the United States provide nearly \$2.9 trillion of financing to U.S. companies<sup>2</sup>. Borrowers range from large blue-chip companies like IBM to industrial companies like U.S. Steel to middle market companies like Sizzling Platter (which owns Little Caesars and Sizzler). The syndicated loan market – a market that continued to provide financing to U.S. companies in the downturn – is a critical component of U.S. corporate financing. Collateralized Loan Obligations (CLOs) provide considerable support to the non-investment grade segment of the syndicated loan market. However, the risk retention provisions of Title IX could have a considerable impact on CLOs – and could materially reduce credit availability to American companies.

### **What is a syndicated loan?**

The Shared National Credit Review defines a syndicated loan as a loan that is at least \$20 million and has at least three bank lenders. There are more than \$1.5 trillion syndicated loans outstanding and another \$1.3 trillion of commitments to lend; this financing supports thousands of large and small companies in the U.S. Syndicated loans have been used by companies for at least 50 years; they are not new, but rather are a tried and true way of providing large amounts of financing to U.S. companies. Over \$500 million of these loans are held by non-bank lenders.

Essentially, in a syndicated credit facility, each lender, severally, makes the loan or commits to make loans. Each lender makes its own credit analysis of the borrower and assessment of the facility or loan, with the opportunity to review and comment on proposed terms, conditions and documentation. An agent provides administrative functions to enable the group of lenders to lend and be repaid in a coordinated and seamless manner for the convenience of the borrower and the lender group. Borrowers also provide financial information on an on-going basis to the lender group which is distributed by the agent to the lenders. In addition, many of the borrowers (and loans) are rated, providing considerable transparency to the lender.

The syndicated loan process clearly makes borrowing easier for the borrower. If not for syndicated lending facilities, companies borrowing large sums would have to engage in negotiations, documentation preparation and borrowing mechanics with many lenders on a bilateral basis. Furthermore, syndicated loans are safer for borrowers than a series of bilateral loans. If a company defaults under a covenant in a syndicated loan, remedies would be pursued with a vote of at least a majority of the lenders.

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<sup>1</sup> The Loan Syndication and Trading Association (“the LSTA”) is a trade organization that represents over 300 firms engaging in loan syndication and trading activities. The LSTA’s membership includes buy- and sellside institutions, as well as law firms, consulting firms, accounting firms and information providers.

<sup>2</sup> Shared National Credit Review, September 2009. The Shared National Credit Review is jointly run by the Federal Reserve, the FDIC, the OCC and the OTS, and reviews and classifies any loan or loan commitment of \$20 million or more, held by three or more federally supervised institutions.

If a company defaults under a covenant in a series of bilateral agreements, individual lenders could race to get paid first, possibly leading to the quicker financial demise of a borrower.

### **How have syndicated loans performed during the market downturn?**

Unlike a number of other asset classes, syndicated loans performed well in the worst financial crisis since the Great Depression. Though default rates did climb, they retrenched quickly and sharply. As of July 2010, the trailing 12-month non-investment grade default rate is 3.47%. Importantly, according to Moody's, recovery given default on loans in the most recent downturn (77.8%) was comparable to the previous downturn of 2001-2002 (77.9%).

### **Why would the credit risk retention requirement hurt syndicated loans and – by extension – corporate borrowers?**

Title IX, Subtitle D, Section 941 is designed to align interests of securitizers and investors. However, risk retention, the mechanism by which it attempts to align interests, could inadvertently disrupt the syndicated loan market. Moreover, it could reduce financing to U.S. non-investment grade companies at exactly the time they will need it.

In Title IX, Subtitle D, Section 941, the term “asset-backed security” is defined as “a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset” including *a collateralized mortgage obligation, a collateralized debt obligation, a collateralized bond obligation, a collateralized debt obligation of ABS, a collateralized debt obligation of collateralized debt obligations....*” In addition, Sec. 15G (c) (1)(F) states that the regulations shall “establish appropriate standards for retention of an economic interest with respect to collateralized debt obligations, and similar instruments collateralized by other asset-backed securities...”

While the main target of the legislation appears to be mortgage backed securities and CDOs of asset backed securities, Collateralized Loan Obligations (CLOs) might arguably be captured in the CDO definition, and hence might be subject to the risk retention requirement.

This would be unfortunate because CLOs are fundamentally different from – and performed very differently than – the CDOs of ABS the legislation appears to target. First, CLO portfolios are actively managed by a third party asset manager; second, CLOs typically hold liquid and transparent corporate loans and thus do not pose the same risks as mortgage-backed securities or asset-backed CDOs; third, CLOs have performed very well in the downturn; and fourth, non-investment grade U.S. companies rely heavily on CLOs as a source of financing. Legislation that threatens the existence of CLOs could reduce funding to these companies.

## Why are CLOs so important?

The syndicated loan market supported the growth of Corporate America in the 2000s. According to the S&P/LSTA Leveraged Loan Index, the volume of outstanding term loans to non-investment grade companies totaled roughly \$600 billion at the end of 2008. CLOs, a type of securitization vehicle, purchased many of these loans, allowing more non-investment grade companies to secure financing. CLOs accounted for roughly 60% of the investment in non-investment grade term loans between 2000 and 2006<sup>3</sup>. All told, CLOs invested in nearly \$300 billion in corporate loans, and today hold almost half of all outstanding non-investment grade term loans. However, as securitization ground to a halt in late 2007, so did CLO issuance, which declined from more than \$80 billion in 2007 to less than \$1 billion in 2009. If new CLO formation does not recover, credit to non-investment grade U.S. companies could be drastically reduced.

## Why are CLOs unique?

Many people assume all securitizations are the same. In fact, CLOs have many characteristics that make them particularly safe and transparent.

- The vast majority of CLO portfolios are *actively* managed by experienced and trusted asset managers such as Eaton Vance, PIMCO and INVESCO.
- Most CLOs own portions of just 150-200 large corporate loans; the CLO managers know each of the loans, and make daily decisions on whether to buy or sell these loans. CLOs do not make material investments in asset-backed securities.
- The underlying corporate loans are large (usually over \$100 million) and transparent: Most of these loans are publicly rated by Standard & Poor's, Moody's or Fitch, they are liquid and trade in the secondary loan market, and they are valued daily by third party pricing services.
- CLOs have many tests that require managers to maintain the quality and diversity of their loan portfolios. These tests, which include overcollateralization tests, weighted average ratings factor tests, interest coverage tests, and weighted average life tests among others, are mandated by the CLOs' indentures and an independent trustee verifies the tests.
- Investors in CLOs receive monthly trustee reports that detail all the tests, the performance of the portfolio, and the performance of each individual loan.
- CLOs have structures to align the interest of managers and investors. The CLO manager has the majority of his/her management fees paid at the same time as or just prior to the equity receiving payments. In addition, some CLO managers are able to hold equity in their CLOs.

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<sup>3</sup> Standard & Poor's LCD

- The “structuring bank” acts as an agent for the CLO manager. While banks do organize CLOs, these banks generally are not securitizing their own assets. Instead banks that structure CLOs (“structuring banks”) actually work as agents for asset managers such as PIMCO and Eaton Vance. When a CLO is being put together, an asset manager will engage a structuring bank to arrange the transaction, and provide short term financing so that the manager can build a portfolio. A portion of these loans might have been originated by the structuring bank, but most of them are originated by other banks. *Most importantly, the asset manager tells the structuring bank which loans to buy.* The asset manager is the driving force, not the structuring bank, and the asset manager continues to have discretion over asset purchase and disposition in the portfolio after closing.

### **How have CLOs performed?**

Considering the magnitude of the financial crisis, CLOs have performed remarkably well. Despite suffering through the worst financial downturn since the Great Depression, *nearly 80% of CLO Aaa tranches remain rated Aa or better* – a remarkably good performance. In addition, CLOs did not suffer the widespread defaults seen on CDOs of ABS. Moreover, recognizing their strong performance, the rating agencies have begun *upgrading* CLO notes.

### **What would be the impact of requiring “securitizers” and/or “originators” to retain 5% of the credit risk?**

Title IX, Subtitle D, Section 941 recommends that the “securitizer” to retain 5% of the credit risk of the assets that are securitized. In addition, regulators may require the “securitizer” to share the risk retention with the “originator.” These definitions appear to be targeted toward asset-backed securities originated by the securitizing institution; however, they do not appear to contemplate a CLO that is actively managed by a third party. As a result, the architecture simply does not work for CLOs, and would seriously impede new CLO formation. This would be problematic for the non-investment borrowers that rely on CLOs.

#### *Securitizer*

In Sec. 15G(a)(3), the “securitizer” is defined as “A) an issuer of an asset-backed security or B) a person who organizes and initiates an asset backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer.”

For a CLO, the securitizer could be interpreted as either the structuring bank or the CLO itself. As noted above, CLO structuring banks help set up CLOs for the managers, but it is the CLO manager that picks the loans that go into the CLO. In this regard, the structuring banks mostly work as agents for the CLO portfolio managers. In turn, it is unfair to require structuring banks to hold on to risk in a portfolio *they are simply sourcing* at the direction of another party.

The CLO structurer earns roughly 100 bps for its services; this is insufficient to cover the cost of retaining 5% of the credit risk of a portfolio loans. If the CLO structurer is forced to retain the risk, it is likely that new CLO formation would end.

The CLO manager earns roughly 50 bps per year to manage the CLO. If the CLO itself were forced to retain the credit risk of the portfolio, new CLO formation might be significantly hampered. If the risk retention were structured in the form of a horizontal equity slice, some new CLO formation might be feasible, though the scale would likely decline markedly. If the risk retention took the form of a vertical pro rata strip, few CLO managers would be able to source the funds, and CLO formation would likely cease.

### *Originator*

In Sec. 15G(a)(4), the term “originator” means a person who “A) through the extension of credit or otherwise, creates a financial asset that collateralizes an asset-backed security; and B) sells an asset directly or indirectly to a securitizer.”

If all originators were required to retain risk, this could unsettle the entire non-investment grade syndicated loan market. As mentioned above, most syndicated loans are structured with many banks jointly providing a large loan to a company; thus *all* banks in a syndicated loan to a non-investment grade company might be considered originators. Suppose Bank “A” participates in a \$2 billion loan with 20 other lenders, and is allocated \$100 million (which is too large a position to hold in its entirety). For risk management purposes, Bank A sells \$50 million of its position to Bank B, and retains \$50 million for its own books. A year later, Bank B sells \$5 million of its position to a CLO. Now, without its knowledge, Bank A has (i) extended credit and (ii) sold an asset *indirectly* to a securitizer. In turn, Bank A would have to find and purchase an additional \$50 million of the loan in the secondary market in order to hold “5% of the credit risk” of the \$2 billion loan. This is particularly problematic because first, the banks’ actions would be constrained by activities that could occur years after the origination of the loan and, second, it would force sellers of loans to track the path of that piece of the loan throughout the life of the loan.

This capability does not currently exist in the secondary loan market. Thus, requiring an “originator” to retain 5% of the credit risk could either severely hamper the secondary loan market or it could force banks to refuse to ever sell part of a loan to a CLO.

In summary, if it is applied to CLOs, risk retention *will* reduce CLO formation. The magnitude of the reduction in CLO formation would be driven by the amount retained, the form the retention takes and the entity that must retain the risk.

### **Why does it matter if CLO formation is reduced?**

For nearly 20 years, CLOs have provided financing to U.S. companies. The recovery of CLO formation is necessary for U.S. non-investment grade companies to obtain sufficient growth capital in the next several years.

In addition, these companies also need to cope with their refinancing needs. In 2008, there were roughly \$600 billion of non-investment grade term loans; CLOs currently hold roughly \$250 billion of these loans.

The bulk of these non-investment grade term loans will mature in the coming years; more than \$400 billion must be refinanced or repaid by 2014. At the same time that these companies require refinancing, the existing generation of CLOs will be ending their reinvestment period – and will not be able to participate in new loans. Ultimately, there could be a roughly \$250 billion gap between companies' refinancing needs and lenders' ability to provide financing. This gap could materially drive up the cost of credit for companies; it could make some companies face liquidity crises – or even bankruptcy.

The potential shut-down of a market that has supported non-investment grade companies for nearly two decades, that is pivotal to providing growth capital to these companies, and that could supply refinancing capital would be very unfortunate. It is doubly unfortunate if this is the inadvertent result of a policy that was intended for a very different product.

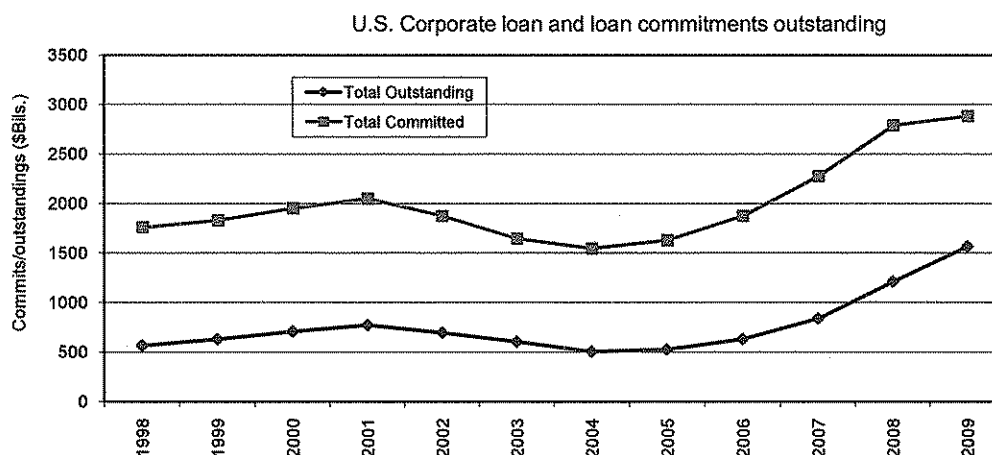
# Syndicated loans and CLOs

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The Loan Syndications and Trading Association is the trade association for the floating rate corporate loan market. The LSTA promotes a fair, orderly, and efficient corporate loan market and provides leadership in advancing the interest of all market participants. The LSTA undertakes a wide variety of activities to foster the development of policies and market practices designed to promote just and equitable marketplace principles and to encourage cooperation and coordination with firms facilitating transactions in loans and related claims.



## U.S. Corporate loan market is a vital source Of capital for American business



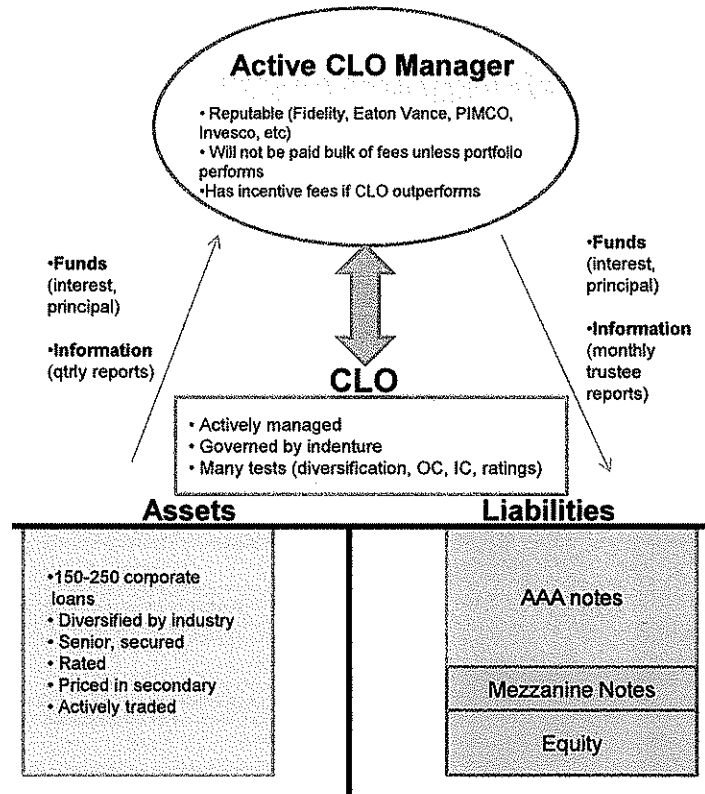
- According to government data, the U.S. syndicated loan market totals nearly \$2.9 trillion of committed lines and outstanding loans
- It is a key source of financing for many large and middle market companies in the U.S.

Source: Shared National Credit Review





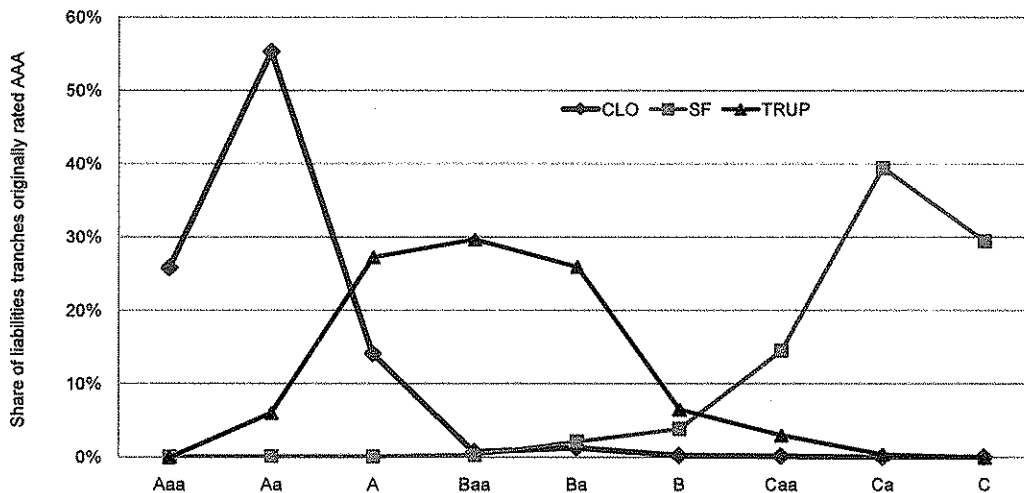
## How a CLO works



**LSTA**  
Liquidity Services Trust Association

## CLO notes performed relatively well

Moody's CDO AAA rating transition

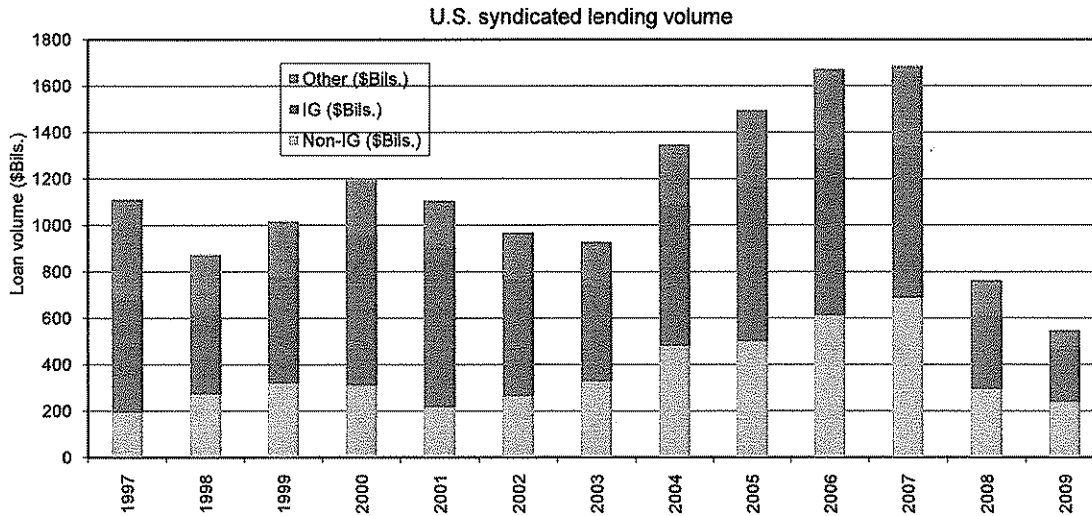


- ▣ More than 80% of CLO liabilities originally rated AAA remain rated AA or better
- ▣ CLO notes are now being upgraded

Source: Wells Fargo, Moody's Investor Service

**LSTA**  
Liquidity Services Trust Association

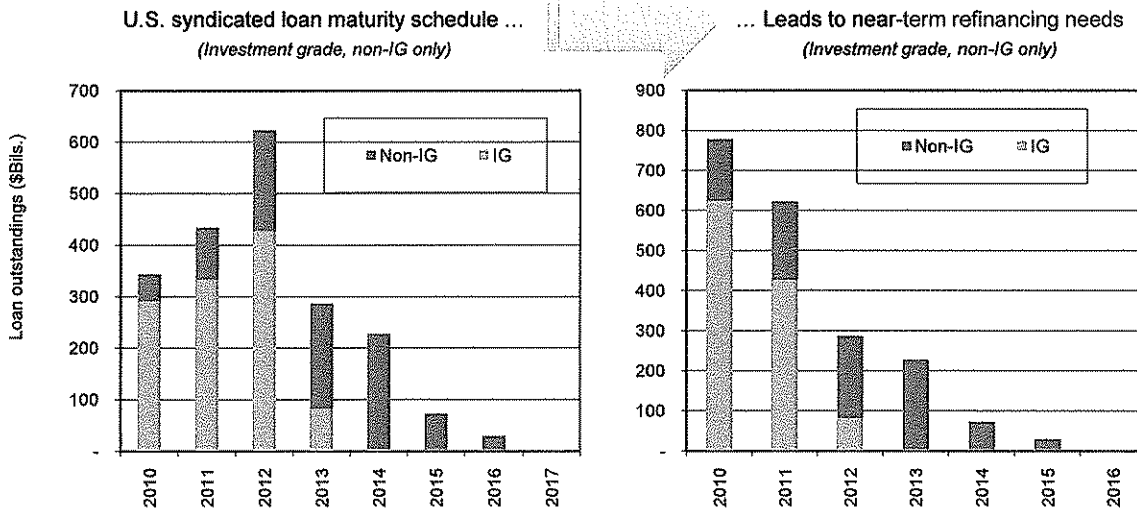
# U.S. syndicated lending volume



Source: ThomsonReuters LPC



# U.S. syndicated loan refinancing needs



- 13 Outstanding loans are normally refinanced at least a year prior to scheduled maturity
- 14 This suggests more than \$1 trillion of loans to be refinanced in the next two years

Source: ThomsonReuters LPC

